APPENDIX

Revenue Act of 1942, c. 619, 56 Stat. 798, amending Revenue Act of 1936, Section 23:

SEC. 121. NON-TRADE OR NON-BUSINESS DEDUCTIONS.

(a) *Deduction for Expenses.*—Section 23(a) (relating to deduction for expenses) is amended to read as follows:

"(a) *Expenses*—

* * * * * * * * *

"(2) *Non-trade or non-business expenses.*—In the case of an individual, all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income."

* * * * * * * * *

(e) *Retroactive Amendment to Prior Revenue Acts.*—For the purposes of the Revenue Act of 1938 or any prior revenue Act the amendments made to the Internal Revenue Code by this section shall be effective as if they were a part of such revenue Act on the date of its enactment.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

Art. 23(a)-15 (as inserted by T.D. 5196, 1942-2 Cum. Bull. 96, 97-100, and amended by T.D. 5280, 1943 Cum. Bull. 1022, and T.D. 5331, 1944-4 Int. Rev. Bull. 4). *Nontrade or Nonbusiness Expenses.*—(a) *In general.* Subject to the qualifications and limitations in Chapter 1 and particularly in section 24, as amended, an expense may be deducted under section 23(a) (2) only upon the condition that:

(1) it has been paid or incurred by the taxpayer during the taxable year (i) for the production or collection of income which, if and when realized, will be required to be included in income for Federal income tax purposes, or (ii) for the management, conservation, or maintenance of property held for the production of such income; and

(2) it is an ordinary and necessary expense for either or both of the purposes stated in (1) above.

The term "income" for the purpose of section 23(a)(2) comprehends not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years; and is not confined to recurring income but applies as well to gains from the disposition of property. For example, if defaulted bonds, the interest from which if received would be includible in income, are purchased with the expectation of realizing capital gain on their resale, even though no current yield thereon is anticipated, ordinary and necessary expenses thereafter incurred in connection therewith are deductible. Similarly, ordinary and necessary expenses incurred in the management, conservation or maintenance of a building devoted to rental purposes are deductible notwithstanding that there is actually no income therefrom in the taxable year, and regardless of the manner in which or the purpose for which the property in question was acquired. Expenses incurred in managing, conserving, or maintaining property held for investment may be deductible under this provision even though the property is not currently productive and there is no likelihood that the property will be sold at a profit or will otherwise be productive of income and even though the property is held merely to minimize a loss with respect thereto. The expenses, however, of carrying on transactions, which do not constitute a trade

or business of the taxpayer and are not carried on for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income, but which are carried on primarily as a sport, hobby, or recreation are not allowable as nontrade or nonbusiness expenses.

Expenses, to be deductible under section 23(a) (2), must be "ordinary and necessary," which presupposes that they must be reasonable in amount and must bear a reasonable and proximate relation to the production or collection of taxable income or to the management, conservation, or maintenance of property held for the production of income.

(b) Except for the requirement of being incurred in connection with a trade or business, a deduction under this section is subject to all the restrictions and limitations that apply in the case of the deduction under section 23(a) (1) (A) of an expense paid or incurred in carrying on any trade or business. This includes restrictions and limitations contained in section 24, as amended. Section 24 (a) (5), as amended, continues to disallow any amount otherwise allowable as a deduction (whether under section 23(a) (2) or otherwise) which is allocable to one or more classes of tax-exempt income, other than interest, and has the effect in addition of disallowing a deduction under section 23(a) (2) for amounts otherwise allowable under that section which are allocable to tax-exempt interest.

Thus any amount allocable to the production or collection of one or more classes of income which is not includible in gross income or to the management, conservation or maintenance of property held for the production of such income is not deductible under section 23(a) (2). Nor does section 23(a) (2) allow any expenses which are disallowed by any of the provisions of Chapter 1 of the Code.

Capital expenditures, and expenses of carrying on transactions which do not constitute a trade or business of the taxpayer and are not carried on for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income, but which are carried on primarily as a sport, hobby, or recreation are not allowable as nontrade or nonbusiness expenses. The question whether or not a transaction is carried on primarily for the production of income or for the management, conservation, or maintenance of property held for the production or collection of income, rather than primarily as a sport, hobby, or recreation, is not to be determined solely from the intention of the taxpayer but rather from all the circumstances of the case, including the record of prior gain or loss of the taxpayer in the activity, the relation between the type of activity and the principal occupation of the taxpayer, and the uses to which the property or what it produces is put by the taxpayer.

Among expenditures not allowable under section 23(a) (2) are the following: Commuters' expenses; expenses of taking special courses or training; expenses for improving personal appearance; the cost of rental of a safe-deposit box for storing jewelry and other personal effects; and expenses such as expenses in seeking employment or in placing oneself in a position to begin rendering personal services for compensation, campaign expenses of a candidate for public office, bar examination fees and other expenses incurred in securing admission to the bar, and corresponding fees and expenses incurred by physicians, dentists, accountants, and other taxpayers for securing the right to practice their respective professions.

Fees for services of investment counsel, custodian fees, clerical help, office rent, and similar expenses paid or incurred by a taxpayer in connection with investments held by him are deductible under section 23(a)

(2) only if (1) they are paid or incurred by the taxpayer for the production or collection of income, or for the management, conservation, or maintenance of investments held by him for the production of income; and (2) they are ordinary and necessary under all the circumstances, having regard to the type of investment and to the relation of the taxpayer to such investment.

Ordinary and necessary expenses paid or incurred in connection with the management, conservation, or maintenance of property held for use as a residence by the taxpayer are not deductible. However, ordinary and necessary expenses paid or incurred in connection with the management, conservation, or maintenance of property held by the taxpayer as rental property are deductible even though such property was formerly held by the taxpayer for use as a home.

Expenditures incurred by an administrator or executor in securing the processes and orders of the court having jurisdiction over the probate of the estate, or in collecting the assets of the estate (other than income which, if and when realized, must be reported by the estate for income tax purposes), or in adjusting claims against the decedent, or in distributing the remaining assets to the beneficiaries, or in conserving the assets for ultimate distribution to the parties entitled thereto, are not deductible under this section. Ordinary and necessary expenses, however, which are paid or incurred during the taxable year by an administrator or executor for the production or collection of income which, if and when realized, must be reported by the estate for income-tax purposes, such as fees for collecting rents on property in the estate of the decedent, or for collecting interest or dividends on securities in that estate, or which are paid or incurred during the taxable year for the management, conservation, or maintenance of property in the estate of the decedent held for the production of income, the income from which, if and when

realized must be reported by the estate for income tax purposes, such as expenditures for insurance or repairs, or expenditures of a similar nature, are deductible under this section at the option of the taxpayer notwithstanding that deductions therefor are allowable under section 812(b) in computing the gross estate subject to the estate tax, provided the requisite statement and waiver are filed. (See section 162(e).)

The ordinary expenditures of administration incurred in a receivership or bankruptcy proceeding are not deductible. Such expenditures include expenditures incurred in the performance of the ordinary duties of a receiver or trustee in bankruptcy, as, for example, fees paid to the attorney for the petitioning creditors, fees paid to the appraisers, and disbursements which are made in connection with the proceeding and which look toward the collection of the assets and their preservation pending ultimate distribution to the parties entitled thereto.

Reasonable amounts paid or incurred by a trustee on account of trustees' fees and other expenses which are ordinary and necessary in connection with the production or collection of trust income or with the management, conservation, or maintenance of trust property held for the production of income are deductible, notwithstanding that the trust is not engaged in a trade or business.

Reasonable amounts paid or incurred for the services of a guardian or committee for a ward or minor, and other expenses of guardians and committees which are ordinary and necessary, in connection with the production or collection of income inuring to the ward or minor, or in connection with the management, conservation, or maintenance of property, held for the production of income, belonging to the ward or minor, are deductible.

It is immaterial whether the expenses of fiduciaries are paid from the corpus of the estate or from income.

Expenses derive their character not from the fund from which they are paid, but from the purposes for which they are incurred.

Expenditures incurred in defending or perfecting title to property, in recovering property (other than investment property and amounts of income which, if and when recovered, must be included in income), or in developing or improving property, constitute a part of the cost of the property and are not deductible expenses. Attorneys' fees paid in a suit to quiet title to lands are not deductible; but if the suit is also to collect accrued rents thereon, that portion of such fees is deductible which is properly allocable to the services rendered in collecting such rents. Expenditures incurred in protecting or asserting one's rights to property of a decedent as heir or legatee, or as beneficiary under a testamentary trust, are not deductible expenses. Expenditures incurred for the purpose of preparing tax returns (except to the extent such returns relate to taxes on property held for the production of income), for the purpose of recovering taxes (other than recoveries required to be included in income), or for the purpose of resisting a proposed additional assessment of taxes (other than taxes on property held for the production of income) are not deductible expenses under this section, except that part thereof which the taxpayer clearly shows to be properly allocable to the recovery of interest required to be included in income.

The deduction of an item otherwise allowable under section 23(a) (2) will not be disallowed simply because the taxpayer also had an election under chapter 1 to treat it as a capital expenditure, rather than to deduct it as an expense. (See section 24(a)(7), added by section 130(a) of the Revenue Act of 1942.) Where, however, the item may properly be treated only as a capital expenditure or where it was properly so treated under an option granted in chapter 1, no deduction is

allowable under this section; and this is true regardless of whether any basis adjustment is allowed under section 113.

(c) The provisions of section 23(a) (2) are not intended in any way to disallow expenses which would otherwise be allowable under section 23(a) (1) or the regulations applicable thereto, or under any other section of the Internal Revenue Code or the regulations applicable thereto. Double deductions are not permitted. Amounts deducted under one provision of the Internal Revenue Code can not again be deducted under any other provision thereof.

Art. 24-2. *Capital expenditures.*—Amounts paid for increasing the capital value or for making good the depreciation (for which a deduction has been made) of property are not deductible from gross income. (See section 23(l).). Amounts expended for securing a copyright and plates, which remain the property of the person making the payments, are investments of capital. The cost of defending or perfecting title to property constitutes a part of the cost of the property and is not a deductible expense. The amount expended for architects' services is part of the cost of the building. Commissions paid in purchasing securities are a part of the cost price of such securities. Commissions paid in selling securities, when such commissions are not an ordinary and necessary business expense, are an offset against the selling price. Expenses of the administration of an estate, such as court costs, attorneys' fees, and executors' commissions, are chargeable against the corpus of the estate and are not allowable deductions. Amounts to be assessed and paid under an agreement between bondholders or shareholders of a corporation, to be used in reorganization of the corporation, are investments of capital and not deductible for any purpose in returns of income. (See article 22(a)-17.)

An assessment paid by a shareholder of a national bank on account of his statutory liability is ordinarily not deductible but, subject to the provisions of the Act, may in certain cases represent a loss. Expenses of the organization, of a corporation, such as incorporation fees, attorneys' and accountants' charges, are capital expenditures and not deductible from gross income. A holding company which guarantees dividends at a specified rate on the stock of a subsidiary corporation for the purpose of securing new capital for the subsidiary and increasing the value of its stock holdings in the subsidiary may not deduct amounts paid in carrying out this guaranty in computing its net income, but such payments may be added to the cost of its stock in the subsidiary.

H. R. Rep. No. 2333, 77th Cong., 2d Sess., pp. 46, 74-76 (1942-2 Cum. Bull. 372, 410, 429):

6. NONTRADE OR NONBUSINESS DEDUCTIONS

The existing law allows taxpayers to deduct expenses incurred in connection with a trade or business. Due partly to the inadequacy of the statute and partly to court decisions, nontrade or nonbusiness expenses are not deductible, although nontrade or nonbusiness income is fully subject to tax. The bill corrects this inequity by allowing all of the ordinary and necessary expenses paid or incurred for the production or collection of income or for the management, conservation or maintenance of property held for the production of income. Thus, whether or not the expense is in connection with the taxpayer's trade or business, if it is expended in the pursuit of income or in connection with property held for the production of income, it is allowable.

SECTION 118. NONTRADE OR NONBUSINESS DEDUCTIONS

This amendment allows a deduction for the ordinary and necessary expenses of an individual paid or incurred during the taxable year for the production and collection of income, or for the management, conservation, or maintenance of property held by the taxpayer for the production of income, whether or not such expenses are paid or incurred in carrying on a trade or business, and also allows a deduction for the exhaustion and wear and tear (including a reasonable amount for obsolescence) on property held for the production of income, whether or not such property is used by the taxpayer in a trade or business.

For an expense to be deductible under this section, it must have been incurred either (1) for the production or collection of income, or (2) for the management, conservation, or maintenance of property held for the production of income. Ordinary and necessary expenses so paid or incurred are deductible under section 23(a)(2) even though they are not paid or incurred for the production or collection of income of the taxable year or for the management, conservation, or maintenance of property held for the production of such income. The term "income" for this purpose comprehends not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years, and is not confined to recurring income but applies as well to gain from the disposition of property. Expenses incurred in managing or conserving property held for investment may be deductible under this provision even though there is no likelihood that the property will be sold at a profit or will otherwise be productive of income. The expenses, however, of carrying on a transaction which does not constitute a trade or business of the taxpayer and is not carried on for the production of income or for the management, con-

servation, or maintenance of property, but which is carried on primarily as a sport, hobby, or recreation are not allowable as nontrade or nonbusiness expenses.

Expenses to be deductible under Section 23(a)(2), must be ordinary and necessary, which rule presupposes that they must be reasonable in amount and must bear a reasonable and proximate relation to the production or collection of income, or to the management, conservation, or maintenance of property held for that purpose.

A deduction under this section is subject, except for the requirement of being incurred in connection with a trade or business, to all the restrictions and limitations that apply in the case of the deduction under section 23(a)(1)(A) of an expense paid or incurred in carrying on any trade or business. Section 24(a)(5), as amended by this section, while continuing to disallow any amount allowable as a deduction, whether under section 23(a)(2) or otherwise, which is allocable to one or more cases of tax-exempt income, other than interest, has the effect in addition of disallowing a deduction under section 23(a)(2) for amounts allowable under that section which are allocable to tax-exempt interest.

Expenses incurred by an administrator or executor in the administration of the estate of a decedent, such, for example, as expenses in securing the processes and orders of the court having jurisdiction over the probate of an estate, or in adjusting claims against the estate, or in distributing the remaining assets to the beneficiaries, are not deductible under this section. Ordinary and necessary expenses, however, which are paid or incurred during the taxable year by an administrator or an executor for the production or collection of income which must be reported by the estate for income tax purposes, may be claimed as deductions under this section notwithstanding that deductions therefor are allowable under

section 812(b) in computing the gross estate subject to the estate tax. Accordingly, subsection (c) of this section amends section 162 to provide that no deduction shall be allowed under section 23(a) (2) in computing the net income of the estate for amounts for which there may have been or has already been allowed a deduction under section 812(b) in computing the net estate of the decedent. The present amendment would not allow as a deduction under section 23(a) (2) for income tax purposes any amount which is allowable under section 812(b) as a deduction in computing the net estate of a decedent for estate tax purposes, unless the Commissioner receives a statement, filed within the time and in the manner and form prescribed by him, to the effect that the amount in question has not been claimed or allowed as a deduction under section 812(b) and that the right to have such items allowed at any time as a deduction under section 812(b) is waived.

Subsection (d) of this section amends section 23(1) of the Internal Revenue Code so as to allow, in addition to the deduction allowable under the existing law, a deduction for the exhaustion, wear and tear of property held by the taxpayer for the production of income whether or not the property in question is used in the trade or business of the taxpayer, including a reasonable allowance for obsolescence. Except for this, the new allowance is subject to the same limitations and restrictions which have been applicable under this section prior to the present amendment.

The amendments made to the Internal Revenue Code by this section are applicable to all taxable years beginning after December 31, 1938. These amendments shall also be effective as if they were a part of the Revenue Act of 1938 or any prior revenue act on the date of its enactment.

Sen. Rep. No. 1631, 77th Cong. 2d Sess., pp. 87-88 (1942-2 Cum. Bull. 504, 570):

SECTION 121. NON-TRADE OR NON-BUSINESS DEDUCTIONS.

This section is the same as section 118 of the House Bill except that subsection (c) of that section has been omitted therefrom and now appears as section 163 and a clerical amendment has been made in subsection (b). The amendemnt made by this section allows a deduction for the ordinary and necessary expenses of an individual paid or incurred during the taxable year for the production and collection of income, or for the management, conservation, or maintenance of property held by the taxpayer for the production of income, whether or not such expenses are paid or incurred in carrying on a trade or business, and also allows a deduction for the exhaustion and wear and tear (including a reasonable amount for obsolescence) on property held for the production of income whether or not such property is used by the taxpayer in a trade or business.

For an expense to be deductible under this section, it must have been incurred either (1) for the production or collection of income, or (2) for the management, conservation, or maintenance of property held for the production of income. Ordinary and necessary expenses so paid or incurred are deductible under section 23(a) (2) even though they are not paid or incurred for the production or collection of income of the taxable year or for the management, conservation, or maintenance of property held for the production of such income. The term "income" for this purpose comprehends not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years, and is not confined to recurring income but applies as well to gain from the disposition of property. Expenses incurred in managing or conserving property held for investment may be deductible under this provision even though there is no likelihood that the property will be sold at a profit or

will otherwise be productive of income, and even though the property is held merely to minimize a loss with respect thereto. The expenses, however, of carrying on a transaction which does not constitute a trade or business of the taxpayer and is not carried on for the production of income or for the management, conservation, or maintenance of property, but which is carried on primarily as a sport, hobby, or recreation are not allowable as non-trade or non-business expenses.

Expenses, to be deductible under section 23(a)(2), must be ordinary and necessary, which rule presupposes that they must be reasonable in amount and must bear a reasonable and proximate relation to the production or collection of income, or to the management, conservation, or maintenance of property held for that purpose.

A deduction under this section is subject, except for the requirement of being insured in connection with a trade or business, to all the restrictions and limitations that apply in the case of the deduction under section 23(a)(1)(A) of an expense paid or incurred in carrying on any trade or business. Section 24(a)(5), as amended by this section, while continuing to disallow any amount allowable as a deduction, whether under section 23(a)(2) or otherwise, which is allocable to one or more classes of tax-exempt income, other than interest, has the effect in addition of disallowing a deduction under section 23(a)(2) for amounts allowable under that section which are allocable to tax-exempt interest.

Subsection (c) of this section amends section 23(1) of the Code so as to allow, in addition to the deduction allowable under the existing law, a deduction for the exhaustion, wear, and tear of property held by the taxpayer for the production of income, whether or not the property in question is used in the trade or business of the taxpayer, including a reasonable allowance

for obsolescence. Except for this the new allowance is subject to the same limitations and restrictions which have been applicable under this section prior to the present amendment.

The amendments made to the Code by this section are applicable to all taxable years beginning after December 31, 1938. These amendments shall also be effective as if they were a part of the Revenue Act of 1938 or any prior revenue act on the date of its enactment.